Corruption as an informal fiscal system

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Corruption and fiscal systems in developing countries

- ▶ Building **state capacity** essential for structural transformation and **inclusive growth** (Besley & Persson 2010; Kim et al. 2020)

- ▶ Developing countries consistently fail to **invest in fiscal capacity** (Acemoglu et al. 2005; Besley & Persson 2009, 2010, 2014; Gadenne & Singhal 2014)

- ▶ **Corruption is persistent** in developing countries (Bardhan & Mookherjee 2006; Olken 2007; Banerjee et al. 2012; Niehaus & Sukhtankar 2013)

Our premise

- **Corruption can substitute for formal fiscal policies via informal fiscal systems**
    - Central governments do not provide basic funds for local officials to do their jobs
    - Local officials use rents extracted from citizens to provide public services
    - Not officially sanctioned, yet implicitly permitted

- Different from community sanctioned **informal taxation**
  (Olken and Singhal, 2011; Gadenne and Singhal, 2014)
    - Source of fund is bribes, not voluntary and possibly extracted from unrelated activities

This paper

- Use survey data and government reports to document the existence of informal fiscal systems in the bureaucracies of two big developing countries

- Propose model of bureaucratic agency to examine
  - When governments might sustain such systems
  - What are its welfare implications

Petrol costs at police stations in India

- Survey of head of 180 police stations (SHO) in a large state
    - Compare monthly budget received for "Petrol, oil and lubricants" ...
    - ...to budget required, based on price of petrol at time of survey

- The average station experiences a monthly shortfall of INR 14,845 (INR 15,256 if slightly less conservative assumptions)

- The funding gap is large relative to the salary of police officers
    - Media reports that police officers are *"supposed to find other means"*

Flood relief and food security in Pakistan

- **Telephone survey** of 750 bureaucrats (out of 6,204) in 2020

- 82% say gvt expects them to personally fund public services
    - **Services:** flood control and relief, free food to the public, logistics for official visits
    - **Reason:** norm / peer pressure (62% bureaucrats), disciplinary action (76% supervisors)

- 100% report part of these funds come from own pockets
    - Own funds contribute 13%-80% of funding for service
    - Confirmed by 98% of their supervisors (N=35)

Flood relief and food security in Pakistan

Where do these funds come from?

- ▶ **Accounting exercise:** funding required is larger than share of income reported by bureaucrats (15% of income).

- ▶ **Citizen survey:** 82% pay bribes to overcome difficulty in accessing services.

- ▶ **Supervisors:** 90% say government does not provide funds because they know bureaucrats earn bribes.

Model: setup

1. **Politician**
   - ▶ Chooses level of formal taxation and of corruption monitoring
   - ▶ Maximise utility of targeted groups of citizens

2. **Bureaucrat**
   - ▶ In charge of delivering public services
   - ▶ Chooses bribe level and how much to redistribute
   - ▶ Values provision of public services when observable (e.g. career concerns) and extracting rent

Model: results

Two possible equilibrium policies:

- ▶ **Formal fiscal policy:** no bureaucrat funding, positive taxes.
- ▶ **Informal fiscal policy:** positive bureaucrat funding, taxes lower than in formal policy.

Informal fiscal policy chosen if public service delivery easier to monitor than corruption.

Contribution

▶ **Public finance in developing countries:** Acemoglu et al. (2005), Besley & Persson (2009, 2010, 2014), Besley et al. (2013)

⇒ New explanation for low investment in fiscal capacity.

▶ **Informal taxation:** Olken & Singhal (2011), Gadenne & Singhal (2014), Jack & Recalde (2015), Jibao et al. (2017), Lust & Rakner (2018)

⇒ Broader system with different welfare implications.

▶ **Corruption:** Becker & Stigler (1974), Besley & McLaren (1993), Tirole (1996), Olken (2007), Ferraz and Finan (2008), Niehaus & Sukhtankar (2013), Dutta et al. (2013)

⇒ Persistence depends on ability to monitor public services delivery and on choice of fiscal policy.